MERITAS ADVISORS

Comprehensive Wealth Management

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MONTHLY INVESTMENT OUTLOOK

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Meritas Advisors structures portfolios to meet our clients' personal goals and preferences within the scope of their risk tolerance. We strive to manage risk most effectively by utilizing a wider blend of asset classes, with the objective of achieving our client's goals with a reduced amount of overall portfolio volatility.

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Dear Clients and Friends: We hope you all enjoyed a wonderful Independence Day with family and friends. We are so incredibly fortunate to live in this country, a nation founded not upon shared ethnicity, religion or geography, but rather upon the belief that individuals ought to be free to pursue their own notion of happiness and live their lives as they see fit, rather than in a one-size-fits-all society. Thank you to all who sacrificed to protect this dream and gave us the luxury of fretting over the little things, like the ramifications of eating too many hamburgers and brownies on the Fourth!
Lenore Hawkins, MBA, Principal

Volatility Returns

Since Fed Chairman Ben Bernanke's testimony before Congress on May 22nd concerning tapering its current QE programs, the markets have been rockin' and rollin' and trending downwards, yet we keep hearing the pundits say this year's stock market gains have nothing to do with QEInfinity. Just what turnip truck do they think we all fell off? The 10-Year Treasury note yield has risen from 1.8% to 2.5%, a nearly 80% increase in interest rates. Volatility has increased as well with the percentage of days the S&P trading range exceeds 1% rising substantially.

Date Range	Percent of days S&P trading range exceeded 1%
May 22nd – July 5th	70%
April	45%
March	25%
February	32%
January	5%

Bottom Line: *The Fed fueled run up in stock prices may have reached an interim peak. We expect increasing market gyrations in the coming quarters, which could provide some attractive entry points.*

Carry Trade Unwinds

The Federal Reserve's current QE program consists of buying $85 billion in bonds, (mostly debt of the U.S. government and mortgage bonds) every month in order to keep interest rates lower than they would be without Fed intervention, believing that suppressed interest rates will stimulate the economy. This suppression lowers the return on investments across the entire market, leading to what is called *financial repression*, as we've discussed in prior newsletters. This financial repression forces investors to take on more risk than they would otherwise choose in order to achieve investment return requirements. This is especially true for pension fund managers such as CALPERS and endowments.

One technique employed to boost returns in a suppressed environment is the carry trade. You've probably heard this referred to in the news lately with respect to the yen as Japanese exchange rates and the Nikkei index moved around dramatically. This is an example of how the yen carry trade works:

> *An investor borrows 1,000 Japanese yen from a Japanese bank, converts the funds into U.S. dollars and buys a bond in USD for the equivalent amount. In this example, the bond pays 3.5% and the Japanese interest rate is set at 0%. The trader stands to make a profit of 3.5% as long as the exchange rate between the countries does not change. Recently many have anticipated the yen to weaken against the dollar, which would serve to increase returns even more. Professional investors often use this trade because the gains can become very large when leverage is taken into consideration. If the investor in this example uses a common leverage factor of 10:1, then he/she can stand to make a profit of 35% rather than 3.5%. But as always, there is a catch.*

In the past two newsletters we discussed how leverage affects returns. We showed how by borrowing 90% for a home mortgage rather than 80%, a homeowner's gains are amplified when the home's price increases, but the losses are amplified as well if the home's price falls. Here's a quick recap of how leverage/borrowing affects returns to refresh your memory, in case you've yet to have your morning cup of Joe.

Borrow	Total Amount Invested	Up 10%	Up 20%	Down -10%	Down -20%
None	$ 1,000.00	10%	20%	-10%	-20%
10%	$ 1,100.00	11%	22%	-12%	-23%
20%	$ 1,200.00	11%	23%	-13%	-25%
50%	$ 1,500.00	13%	28%	-18%	-33%
90%	$ 1,900.00	15%	34%	-24%	-43%

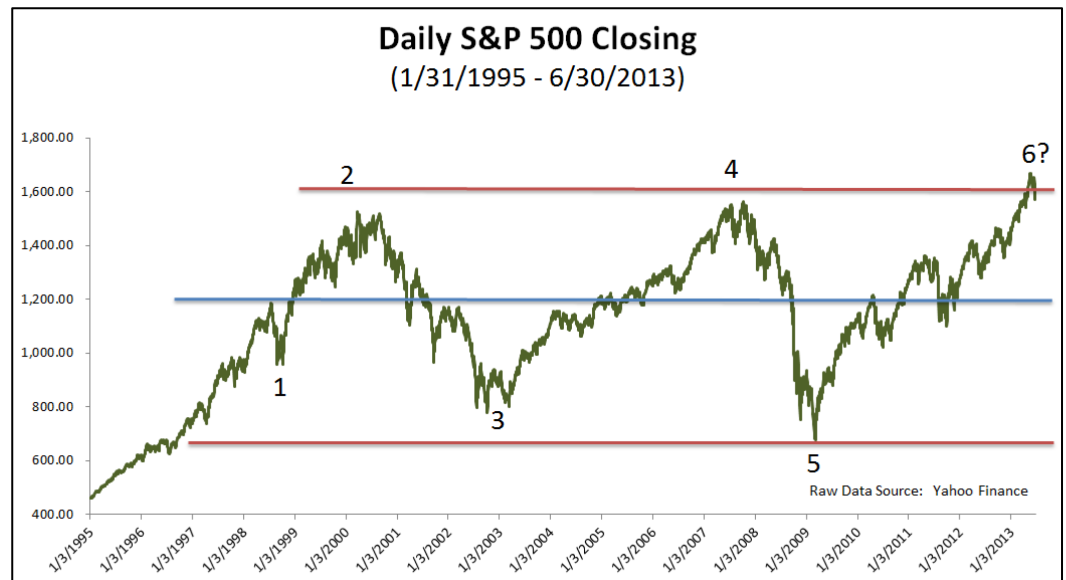
The chart above illustrates the benefit and risks of borrowing to enhance returns. It assumes a 5% interest rate on amounts borrowed. By investing $1,000 and borrowing an additional 50% in order to invest a total of $1,500 in a security that returns 10%, an investor can increase their returns 30% from 10% to 13%, after paying 5% interest on the borrowed amount. The pain from losses is exaggerated as well, if that same investment losses 10%. Rather than just losing 10% from the original amount invested, the investor will lose an additional 80%, to lose a total of 18% on their original investment.

Now back to the carry trade. After Fed Chairman Ben Bernanke's comments concerning potential tapering of QEInfinity in the nearer-than-expected term, bond yields immediately began rising. When bond yields go up, prices go down, so in our example above, the leveraged buyer would experience significantly greater losses due to their leveraged use of the carry trade, thus the rapid unwinding which meant fevered selling of the bonds they'd bought using the borrowed yen, which only exacerbated the downward spiral of bond prices. Oy vey!

Bottom Line: *Financial repression forces investors to take on more risk that they would otherwise in order to generate reasonable returns. This increased risk taking results in more volatile markets.*

Range Bound Investing

Investing luminaries such as Warren Buffet of Berkshire Hathaway and Jeremy Siegel of *Stocks for the Long Run* made their marks in the Investors' Hall of Fame using strategies based on long-term, buy-and-hold investing. While their success speaks for itself, they earned their reputations when that strategy was highly effective, in a long-term bull market where P/Es (Price to Earnings Ratios) kept expanding. That same strategy applied to the broader market can be disastrous in a range-bound market. A portfolio invested in the broader market from 1966 to 1982 would have received no real returns for an entire 16 years, until the next bull market began in 1983. That bull market lasted from 1983 to 2000, when we entered yet another range bound market, as is shown in the chart below.



An investor who bought the broader market at the beginning of the range bound market, (Position 1) on August 31st, 1998 would have lost 19% by October 2002 (Position 3) and 29% by March 2009, (Position 5). That means after *eleven years* of investing in the broader market, the investor would have *lost 29% and that's ignoring inflation!*

An investor who bought at the first peak of this range bound market (Position 2) in March 2000, would have lost 56%, again ignoring inflation, by March 2009, *nine years to lose over half of their investment*. As for the joy over the latest run up, this same investor would have only gained 9% from March 2000 to today, waiting thirteen years to earn just 9% which translates to an annual rate of return of 0.657%, not even keeping up with inflation!

So what's the solution? Sell at market peaks and buy at the bottom? Easy in hindsight but how can anyone reliably identify market peaks and troughs when you are sitting in them? Isn't that market timing, which has been proven repeatedly to be a very effective way to lose money? *We aren't suggesting market timing, but rather price targeting*. This means finding a security, a stock, bond, commodity etc. that we like for fundamental reasons, then identifying a price at which we believe purchasing that security has relatively low risk. *The single most important factor in returns is the starting valuation.*

This is rather intuitive. Let's use buying a house as an example. Home prices have a long and very strong relationship with median household income levels, which makes a lot of sense when you think about it. How much people can pay for a home is dependent primarily on their income. If mortgages interest rates drop dramatically, the down payments required drops and families no longer have to provide evidence of any income nor have good credit, they may be able to buy a more expensive house than when they were required to put 20% down, have good credit and provide proof of stable income. Sound familiar? When that happens the market can be distorted, but eventually the relationship between home prices and income levels will be restored. If a family buys a home when home prices are at or below the historical norms for the relationship between price and income and mortgages are unusually difficult to get, the risk of the home falling in price is much lower than if they buy the home when that relationship is much higher than historical norms and mortgages are available to anyone with or even without a pulse!

It is the same with investing in stocks, bonds or commodities. The frustrating and complicated part is the waiting. We may have to wait a considerable amount of time to see a price that we like and that period of waiting can be expensive, so if we believe that market conditions are not too insanely out of whack with the price we are looking to pay, we might tip toe in, but will hold off until we get within a reasonable range of our target price before we start loading up.

This means that for us, a cash balance is not so much based on a target allocation for a client's portfolio, but rather is a by-product of the level of opportunities we see in the markets. If we believe that conditions are significantly over-bought, we will end up having higher cash balances than if we believe that conditions are over-sold.

In any market, buying at the right valuation is the most important decision. In a range bound market, investors must also identify a price at which they believe they need to sell. In a long-term bull market, investors don't need to worry about selling because prices can continue to go up and up for over a decade. In a range bound market, there is a ceiling for prices and the wise investor identifies where that sits, sells, and patiently waits for the opportunity to buy again.

Meritas recently executed this strategy for our clients with a utilities ETF, ticker symbol XLU. We bought it when we believed that valuations for the stocks within it were attractively priced, then sold when we believed that the prices were becoming entirely too high for the market to withstand.

Bottom Line: *In long-term bull markets the buy-and-hold strategy translates into buy-it-and-forget-it and can serve investors well. In range bound markets, like the one we are in today, investors must be more active, identifying not only a price at which to buy, but also one at which they to sell. Next month we'll discuss this topic further, going into just what generates equity returns.*

Greg Tull's Your Money

There are five allocation components to each client's personalized portfolio at Meritas: stocks, bonds, specialty funds, sector rotation and cash. In most market environments, the correlation between these five is low, which means they tend to move independently of each other. On Friday July 5th, for example, bonds and gold were falling and stocks were rising because of the announcements that day of the improvement in the number of jobs the economy created in June, the increase in the labor force participation rate, and the improvement in wages and earnings. Collectively, market participants are interpreting this news to mean that the economy is improving and the Federal Reserve is therefore more likely to begin "tapering" the quantitative easing program by the end of 2013, possibly as soon as their September meeting. "Tapering" means that the Fed would buy less than their current monthly purchases of a combined $85 billion of Treasury bonds and mortgage backed bonds. The bond market reacted very strongly to this news by pushing the yield on the 10 year Treasury bond from 2.5% to 2.72% in a single day, the largest daily rise since 2010. This continues a short term trend since May 2, 2013 when the yield on the 10 year hit 1.63%, the lowest of 2013 and also the lowest in the past 50+ years.

In the two charts in this section, you can see both how large the move up in interest rates has been in the past couple of months relative to where they began the year, and also how small the move up has been relative to the enormous fall in 10 year rates over the past three decades since they peaked at close to 16% in 1981. The risk of a spike in interest rates is the reason that Meritas has been using shorter duration bonds as the core of clients' fixed income portfolios for the past couple of years. Shorter duration bonds fall less in value than longer duration bonds when interest rates increase. As an example, the year to date return of our favorite low duration bond fund as of July 3rd was +0.12%, while the year to date return of the Barclay's 20+ year Treasury bond (NYSE: TLT, an ETF which is used as a proxy for long duration treasuries in this illustration) was -8% as of July 3rd. On the other hand, the domestic equity index funds that we are using are up between 14% and 19% for the year at this time, mainly because the market believes that the Fed's strategy to get the economy moving is to

drive up the stock market, and further, the market believes that the Fed is likely to be successful in achieving its objectives. Our favorite long/short specialty funds are up 7% to 8% for the year. At present, our sector rotation allocation is in cash, because we do not presently see a specific industry sector that is both substantially undervalued and out of favor, coupled with a potential catalyst to bring it back into favor.

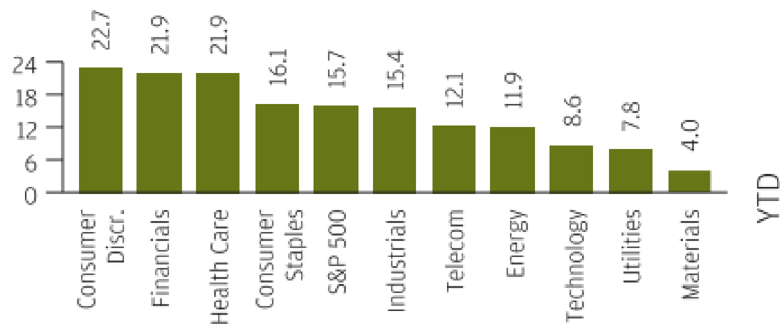
While we do not have a crystal ball as to where the stock market or the bond market is headed, we have some insight into where there are elevated risks in the markets that are worth taking steps to protect against, such as the risk of an increase in interest rates that is currently manifesting itself. If the stock market continues to rise and the bond market continues to fall, or move sideways, our stock allocations will grow beyond their target percentages, the bond allocations will fall below their target percentages, and there will be an opportunity to rebalance by taking profits in stocks (selling high) and investing the proceeds in bonds (buying low) to bring clients' portfolios back into compliance with their recommended asset class allocations. This formulaic approach to investing through the use of disciplined rebalancing helps us to avoid the pitfalls of behavioral finance, a topic we will address in an upcoming piece.

Market Recap

(as of July 5th, 2013)

		Index Returns (%)				
Equities	**Level**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
S&P 500	1632	1.63	1.63	15.68	22.04	70.23
Dow Jones 30	15136	1.55	1.55	16.97	20.38	69.08
Russell 2000	2499	2.87	2.87	19.18	24.79	74.92
Russell 1000 Growth	491.60	1.93	1.93	13.96	18.01	71.40
Russell 1000 Value	514.01	1.44	1.44	17.57	27.06	70.66
MSCI EAFE	1648	0.57	0.57	5.06	19.31	36.58
MSCI EM	917.58	-2.31	-2.31	-11.49	-1.18	9.55
NASDAQ	3479	2.27	2.27	16.00	18.60	72.20
Fixed Income	**Yield**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
U.S. Aggregate	2.55	-1.04	-1.04	-3.45	-2.04	9.85
U.S. Corporates	3.50	-0.90	-0.90	-4.28	-0.17	17.28
Municipals (10yr)	2.90	-0.44	-0.44	-3.19	-0.50	14.61
High Yield	7.02	-0.04	-0.04	1.37	8.90	35.79

	Levels (%)					
Key Rates	**7/5/13**	**6/28/13**	**6/28/13**	**12/31/12**	**7/5/12**	**7/5/10**
2-yr U.S. Treasuries	0.40	0.36	0.36	0.25	0.28	0.63
10-yr U.S. Treasuries	2.73	2.52	2.52	1.78	1.62	3.00
30-yr U.S. Treasuries	3.68	3.52	3.52	2.95	2.72	3.94
10-yr German Bund	1.72	1.73	1.73	1.31	1.39	2.54
3-mo. LIBOR	0.27	0.27	0.27	0.31	0.46	0.53
3-mo. EURIBOR	0.22	0.22	0.22	0.19	0.65	0.80
6-mo. CD rate	N/A	0.27	0.27	0.31	0.49	0.71
30-yr fixed mortgage	4.58	4.58	4.58	3.52	3.86	4.68
Prime Rate	3.25	3.25	3.25	3.25	3.25	N/A



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